Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	CC Docket No. 80-286
Jurisdictional Separations Reform and	)	
Referral to the Federal-State Joint Board	)	

COMMENTS OF VERIZON[1] ON JOINT BOARD RECOMMENDED DECISION

The Joint Board correctly determined that a freeze of separation factors and relationships "will provide much needed simplification and stability to the separations process." Recommended Decision, ¶ 1. The proposed freeze will prevent arbitrary separations changes from distorting the marketplace. The Commission should approve this policy determination and implement such a freeze.

At the same time, the Commission should reject proposals inconsistent with the policy decision underlying the proposed freeze. In particular, the Commission should not adjust dial equipment minutes to reflect internet traffic growth. Such a shift in costs from intrastate to interstate is inconsistent with the intent of the freeze. Regardless, while such traffic is clearly interstate, a separations shift for this traffic would be inconsistent with separations principles that match costs with revenues. This is because, under the Commission's access charge exemption, there has been no interstate cost recovery associated with this traffic. Instead, any recovery has been through intrastate tariffs.

[1] The Verizon telephone companies ("Verizon") are the local exchange carriers affiliated with Verizon Communications Inc., and are listed in an attachment.

I. A Freeze is Consistent With Sound Public Policy

The Joint Board recognizes a number of benefits to its proposed freeze. Such a freeze would "simplify the separations process and thereby reduce regulatory burdens on carriers during the transition from a regulated monopoly to a deregulated, competitive environment in the local telecommunications marketplace." Recommended Decision, ¶ 18. Under the current regime, at least 60 employees and 11 major computer systems are devoted to maintaining the separations data bases and performing separations calculations at Verizon. There are between five and ten basic studies required for each of Verizon's 52 study areas – resulting in a total of more than 475 separate studies. None of these studies would be required under the Joint Board's proposed freeze.

An additional benefit recognized by the Joint Board is that a freeze will result in "more predictable separations results," which will encourage the deployment of "new services and technologies in the marketplace." Recommended Decision, ¶ 17. As Dr. William Taylor previously testified, a separations freeze mitigates the current "distortion in incentives" that results from the separations process. Affidavit of William E. Taylor, ¶ 26 (attached here as Exhibit A and originally filed with Bell Atlantic Comments on Dec. 10, 1997) ("Taylor Affidavit"). As Dr. Taylor explains:

> Freezing separations factors would mean that the regulated firm would make pricing and product decisions that ignored the effects of changes in jurisdictional cost assignments. Because these changes in costs today do not reflect changes in economic costs, the incentives for the regulated firm would be closer to those of unregulated firms in competitive markets when separations factors are held constant.

Id.

While a separations freeze provides significant benefits, there are no countervailing costs associated with such a freeze for price cap companies. The Joint Board recognized that even without a freeze there is "little fluctuation" in relative levels that impact separations. Recommended Decision, ¶ 23. Indeed, since the completion of the transition to the current common line separations factor, the interstate investment allocation ratios for the largest local exchange carriers has varied only around one percent from the multiyear average. *See* data table attached as Exhibit B.

More fundamentally, regardless of the separations method, the division of costs between jurisdictions is arbitrary. This is not a criticism of current separations rules, but merely a function of the nature of the joint use telephone network. A single network provides both interstate and intrastate services. The same switches and lines connect interstate and intrastate calls. As the Commission has recognized, the shared costs of these facilities "cannot be allocated on the basis of cost-causation principles." *Access Charge Reform*, 12 FCC Rcd 15982, ¶ 23 (1997). As a result, "all economists recognize" that any regulatory allocation of these costs must be "arbitrary." Taylor Affidavit, ¶ 7.

Given the arbitrary nature of the task, courts have not attempted to impose a single correct separations method. Indeed, the Supreme Court recognized that "reasonable measures" to attribute costs to state and federal jurisdictions were adequate, and there is no need for "extreme nicety" in such division. *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133, 150 (1930). The Commission has used a variety of methods – including freezing specific factors – to separate costs, but no court has rejected any of these methods as unreasonable. *See, e.g., MCI Telecommunications Corp. v. FCC*, 750 F.2d 135, 141 (D.C. Cir. 1984) (upholding adoption of a frozen factor to separate subscriber plant costs). The Court there recognized that "[c]ost allocation is not purely an economic issue – it necessarily involves policy choices." Here, those policy choices all point to a separations freeze.

II. The Commission Should Not Make An Adjustment For Internet Traffic

The Joint Board makes a powerful case for a complete freeze, but then undercuts its own arguments by suggesting that the Commission not freeze Dial Equipment Minutes, but rather make an adjustment to account for costs associated with internet traffic. *See* Recommended Decision, ¶ 29 (positing a five percent adjustment as a proxy for internet growth). There is no basis for isolating a single potential change and making a separations adjustment. By proposing an arbitrary change to an already arbitrary allocation, the Joint Board potentially would do exactly what a freeze is intended to avoid – interject non-economic separations considerations into pricing decisions for services.[2] The proposal adds uncertainty at a time when both state and federal regulators are attempting to encourage investment by decreasing uncertainty.

1. Internet-bound calls are interstate.

Regardless, there is no basis to support a separations shift of this traffic. This is not because the traffic is intrastate –undoubtedly, it is interstate.

The Commission specifically ruled as such, finding that "the communications at issue here do not terminate at the ISP's local server, as CLECS and ISPs contend, but continue to the ultimate destination or destinations, specifically at a Internet website that

[2] While the Joint Board does not explain the intended ramifications of its proposal, it is clear that if state regulators sought price adjustments as a result of decreased costs assigned to intrastate jurisdictions, carriers would be entitled to an equal and offsetting increase in federal rates. *See* 47 C.F.R. § 61.45(d)(1)(iii) (changes in the separations manual are considered an exogenous cost and eligible for price adjustment).

is often located in another state." *Implementation of Local Competition Provision in the Telecommunications Act of 1996*, 14 FCC Rcd 3689, ¶ 12 (1999). That decision was based on a long line of Commission cases that recognized that "the Commission traditionally has determined the jurisdictional nature of communications by the end points of the communication and consistently has rejected attempts to divide communications at any intermediate points of switching or exchanges between carriers." *Id.* at ¶ 10. *See also Petition for Emergency Relief and Declaratory ruling Filed by BellSouth Corporation*, 7 FCC Rcd 1619 (1992) (one call included transmission from originating carrier to voice mail apparatus); *Teleconnect Co. v. Bell Telephone Co. of Penn.*, 10 FCC Rcd 1626 (1995) (call into 800 "Megacom" service carries through to ultimate destination); *Southwestern Bell Telephone Company*, 3 FCC Rcd 2339 (1988) (credit card call into long distance carrier's switch is part of the same call as the connection to the called party).

Moreover, the decision is consistent with prior Commission decisions that repeatedly recognized that calls to the internet reach a worldwide network going through the provider's gateway. *See MTS and WATS Market Structure*, 97 FCC 2d 682 at 711-12 (1983) ("[a]t its own location the [enhanced service provider] connects the local exchange call to another service or facility over which the call is carried out of state."); *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, 2 FCC Rcd 4305, 4306 (1987) ("[e]nhanced service providers, like facilities-based interexchange carriers and resellers, use the local network to provide interstate services").

While the D.C. Circuit remanded the Commission's decision with respect to reciprocal compensation, it acknowledged that "the Commission has historically been justified in relying on [end to end analysis] when determining whether a particular communication is jurisdictionally interstate." *Bell Atlantic v. FCC*, 206 F.3d 1, 5 (D.C. Cir. 2000). And in the remand proceeding currently underway, while the parties have disagreed on whether carriers are entitled to reciprocal compensation for internet-bound traffic, "the commenters are almost unanimous that ISP-bound traffic is jurisdicitonally interstate." *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Dkt. Nos. 96-98, 99-68, Reply Comments of AT&T Corp. at 1 (filed Aug. 4, 2000).

2. The fact that internet-bound calls are interstate does not mean that the Commission should modify the freeze proposal to make an adjustment for this traffic.

The fact that traffic associated with the internet is jurisdictionally interstate cannot end the inquiry. The Commission has made a specific policy judgment not to allow interstate access charges to recover the costs associated with this traffic. *Access Charge Reform*, 12 FCC Rcd 15982 at ¶ 344 (1997). Because the only tariffed rate recovery associated with that traffic is intrastate – the cost to the ISP of the business line – local telephone companies have categorized the costs associated with this traffic as intrastate for separations purposes.[3] *See Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements*, 4 FCC Rcd 3983, 3987 (1989). This is consistent with Commission requirement that in their separations results, carriers must avoid "a mismatch in costs and revenues." *Determination of Interstate and*

[3] The switching and transport costs all are assigned to intrastate. The interstate jurisdiction is assigned a portion of the fixed common line costs, which are recovered through the interstate subscriber line charge and the presubscribed interexchange carrier charge.

Intrastate Usage of Feature Group A, 4 FCC Rcd 1966, ¶ 66 (1989). Thus, the intrastate categorization for separations purposes is a result of the Commission's policy choice that, at least for the present, there should be no interstate access tariff to recover the costs associated with internet traffic.

Even if a separations shift in this traffic was consistent with Commission separations policy, which it is not, it would serve no purpose and would only bring potential distortion to the marketplace. Given that most states moved their largest carriers from rate of return-based regulation to price cap regulation years ago, the recent growth in internet traffic (and its commensurate costs) are not reflected in their intrastate rates and are not being recovered anywhere. *See* Taylor Affidavit, ¶ 14 (listing the states that already adopted price cap regulation in 1997).

To the extent the cost recovery for this traffic is reflected in intrastate end-user rates however, a shift to the interstate would only result in those same end-users paying for the costs in an increased interstate charge. This is because any exogenous reduction in state rates would trigger an exogenous increase in interstate rates. Under the Commission's recent CALLS access reform decision, all price increases as a result of exogenous cost shifts are targeted to non-traffic sensitive charges, which are recovered in the Common-line element, through an end-user charge. *See* 47 C.F.R. § 61.45(d)(3). No purpose could be served by such a shift, but the potentially dramatic changes associated with moving internet costs between regulatory jurisdictions would cause the exact market disruption the Joint Board seeks to avoid with its proposed freeze.[4]

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[4] Verizon does not separately track internet minutes. Indeed, there is no direct way for it to do so. Regardless, because there is no reason for a separations shift at all, there is no reason to try to quantify the size of such a shift here.

Conclusion

The Commission should adopt the Joint Board's proposed freeze, but reject the suggestion for a prior adjustment for internet traffic.

Respectfully submitted,

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September 25, 2000

Before the

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In the Matter of	)	
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Jurisdictional Separations Reform and	)	CC Docket No. 80-286
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AFFIDAVIT OF WILLIAM E. TAYLOR

1. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), head of its telecommunications economics practice and head of its Cambridge office. My business address is One Main Street, Cambridge, Massachusetts 02142.

2. I have been an economist for over twenty-five years. I received a B.A. degree in economics (Magna Cum Laude) from Harvard College in 1968, a master's degree in statistics from the University of California at Berkeley in 1970, and a Ph.D. in Economics from Berkeley in 1974, specializing in industrial organization and econometrics. I have taught and published research in the areas of microeconomics, theoretical and applied econometrics, and telecommunications policy at academic institutions (including the economics departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology) and at research organizations in the telecommunications industry (including Bell Laboratories and Bell Communications Research, Inc.). I have participated in telecommunications regulatory and judicial proceedings before state public service commissions, the Federal Communications Commission (FCC), the Canadian Radio-Television and Telecommunications Commission and state and federal courts concerning competition, incentive regulation, price cap regulation, productivity, access charges, pricing for economic efficiency, and cost allocation methods for joint supply of video, voice and data services on broadband networks. I filed

affidavits regarding economic aspects of the implementation of Section 272 of the Act in CC Docket No. 96-149 on August 18 and November 14, 1996 where copies of my vita are supplied.

I. Summary and Conclusions

3. In its Notice of Proposed Rulemaking (the "Notice"), the Commission initiates a comprehensive review of its Part 36 jurisdictional separations procedures in light of changes wrought partly by the implementation of the Telecommunications Act of 1996 and partly by continued historical trends in telecommunications market structures, technology, regulation and the law. As part of its submission in this docket, Bell Atlantic has asked me to identify and comment on the salient economic aspects of the Commission's separations procedures and on proposals to modify, reform or eliminate them.

4. From an economist's perspective, jurisdictional cost separations has largely been an uninteresting accounting exercise with limited economic content and an exercise whose usefulness has declined over time. The need to assign costs to jurisdictions is fundamentally legal or administrative, not economic,[1] as one can deduce from the fact that separated costs are rarely used directly or dispositively in the pricing of services in either the interstate or intrastate jurisdictions. Nonetheless, two important economic forces do bear on the consequences of any decision to modify or reform the separations process:

- the movement towards price cap regulation in the federal and state jurisdictions reduces the need for jurisdictional cost separations, as the links between accounting costs and jurisdictional price cap indices disappear, and
- the reduction of entry barriers and growth in competition in telecommunications markets makes the asymmetric application of separations rules to ILECs an artificial competitive disadvantage that can inefficiently distort market outcomes.

Ironically, as the need for cost separations withers away, the consequences of incentive distortions from changes in separations factors-largely inherent and unavoidable-grow larger.

[1] Indeed, jurisdictional cost assignment makes no economic sense because economic costs are assigned on a cost-causal basis, and it is services that cause carriers to incur costs, not jurisdictions.

5. An economic argument for separations reform should take the following points into account:

- A separations process of some sort is necessary until all links-direct and indirect-between accounting costs and service prices are removed. In order to eliminate reliance on the separations process, federal and state regulators must either deregulate-eliminate price regulation altogether-or implement permanent price cap regulation plans that ignore earnings. Nonetheless, until deregulation occurs or such plans are in place, there will be a need to calculate earnings-and thus accounting costs-separately for interstate and intrastate jurisdictions.

- Reform of the current separations process-limiting its impact on prices-is necessary because of market developments. The separations process was created before competition came to most markets along with the need for regulatory parity among competitors. Once markets are opened to competition, jurisdictional cost assignments that affect-directly or indirectly-one competitor's prices or service offerings and not another's will distort the competitive process and deny customers the benefits of efficient competition.[2]

- Reform of the current separations process is also necessary because it will become more difficult to implement the current rules in a competitive environment with changing technology. There has been a reasonable association between incremental (directly assignable) costs and categories of services and a similar association between service categories and jurisdictions. However, in competitive markets where local, long distance and non-telecommunications services are bundled into packages sold at a single price, it is impossible to identify either costs or revenues of individual services.

As a result, continued use of current separations procedures is likely to become more difficult to implement, less accurate and less competitively neutral than it has been in the past.

6. Economic reasoning provides guidance but no clear solution to these problems. As long as prices for one firm in a market opened to competition are regulated-and those regulations depend, however indirectly, on accounting costs-those accounting costs will have to be assigned to regulatory jurisdictions. That assignment may be difficult and may distort the competitive process, improperly favoring entrants or incumbents, old technology or new. However, taking a cue from the price cap regulation literature, one proposed policy for separations reform has certain advantages in the incentives

2 For example, shifts in demand can affect separations factors requiring price responses that unregulated firms would not make. Application of existing rules to new services can constrain prices, distorting the regulated firm's incentives to offer new services.

it supplies to the regulated firm. A freeze in separations factors at their current levels has the property of breaking the link between changes in demand and changes in the proportions of costs assigned to the interstate and intrastate jurisdiction. Decisions on pricing, packaging, and offering new service bundles for all firms would no longer depend on changes in separations factors or formulas but rather on the forward-looking economic costs of the services, market conditions, and-for price-regulated firms-the constant, predictable jurisdictional cost assignment that could affect regulated service prices under certain conditions. While not perfect, a freeze on separations factors would remove one serious component of asymmetric regulation of ILECs: the distortion in incentives caused by the link between changes in demand and changes in separated costs.

II. The Separations Process is Necessarily Arbitrary.

7. At the outset, all economists recognize that after incremental costs are directly assigned to services on the basis of cost-causation, the assignment of the remaining shared fixed and common costs to services (or groups of services or jurisdictions) on a cost basis is arbitrary.[3] In unregulated, competitive markets, cost recovery varies depending on the ability of the firm to hold its price above incremental cost in the face of competition from other firms, each having different costs and having also to recover its shared fixed and common costs somewhere among the markets it serves. In such markets, prices are not driven to incremental cost, nor are markups of price over incremental cost the same for all services or proportional to usage or direct investment. It is in this sense that there is no economic solution to the cost allocation problem; i.e., no economically efficient way to assign shared fixed and common costs of the regulated firm to services with reference only to the costs of supplying those services.[4]

[3] By "shared fixed" costs, I mean costs necessary to provide a group of services that do not vary with the output of those services. "Common" costs are shared fixed costs across all of the services of the firm.

[4] As Alfred Kahn, the dean of regulatory economists and one-time Chairman of the New York Public Service Commission, once put it, "the cost allocation problem is like finding a black cat in a dark room...in which there is no cat."

8. The current method of separating accounting costs between the intrastate and interstate jurisdictions is based largely on relative use, partly on the belief that usage is the main driver of costs and partly in response to the Supreme Court's admonition in Smith v. Illinois to not "ignore altogether the actual uses to which the property is put."[5] Regulated costs are first assigned to various categories of plant and expenses using prescribed rules which generally require direct assignment on a cost-causal basis. Costs in different plant and expense categories are then assigned to the interstate and intrastate jurisdictions using allocation factors generally based on relative usage.

9. To the extent possible, separations rules assign costs on the basis of cost causality, and it is only in the assignment of shared fixed and common costs that arbitrary allocations are made. As a result, we can use separated costs as economic costs for some purposes but not for others. For example, we can use separated costs to detect whether a category of services receives a subsidy, since if incremental revenue exceeds separated cost, it most likely exceeds incremental economic cost. On the other hand, this property does not extend to individual services. As the Commission observes,

> (o)ur separations rules apportion costs among broadly defined classes of services. Because ILECs offer numerous services in each jurisdiction, and because the separations rules uniformly apply to ILECs having diverse cost structures, these rules are not intended to be sufficiently accurate to identify the costs incurred by individual services. (Notice at ¶ 26).

10. In addition, there is no pretense that separations assigns shared fixed and common costs to individual services, groups of services or jurisdictions in the same manner as unregulated firms would recover those costs in competitive markets.

> In a competitive market, cost that are joint and common between two services are borne more heavily by the service that is less price sensitive (more price inelastic). In practice, our separations rules allocate joint and common costs among service classes on some basis, such as relative-use measurements, or fixed factors that are relative-use surrogates and ignore price elasticity. (Notice at ¶ 26).

5 Smith V. Illinois, 282 U.S. at 151, cited in the Notice at footnote 20.

Thus although separated costs are useful for some purposes, they are not useful for others, and at any level of service aggregation, they certainly do not approximate the prices-and thus the implicit cost assignment-that would occur among multiproduct firms in unregulated markets subject to the discipline of competition.

III. Reduced Need for Separations

11. From an economic perspective, the single most telling change that impacts separations reform is the movement in regulatory practice towards "pure" price cap regulation for telecommunications services. The separations process determines accounting costs in each jurisdiction, and regulators-in the past-have used that information in setting prices. To the extent that regulated prices are now determined without reference to jurisdictional earnings or to separated accounting costs, the separations process is no longer strictly necessary to set prices.

12. Price cap regulation also reduces the need to separate costs jurisdictionally to accomplish other goals. By separating prices and price cap indices from accounting costs, price cap regulation reduces the ability of the regulated firm to fund below-cost pricing for some services from contributions from other services. Under pure price cap regulation-where price caps are entirely independent of accounting costs-customers of regulated services cannot be burdened with higher prices as a result of any cost accounting or, indeed, of any investment in competitive activities, because those regulated prices have no dependence on accounting costs.

A. State and federal price cap plans.

13. In its discussion of the need for a separations process, the Notice identifies several continuing uses of separated costs for price-cap-regulated firms: the low-end adjustment in the federal price cap plan, calculation of exogenous cost changes, federal and state earnings reporting requirements and features of state price cap plans that depend on reported earnings (and thus on separated costs).[6] It then

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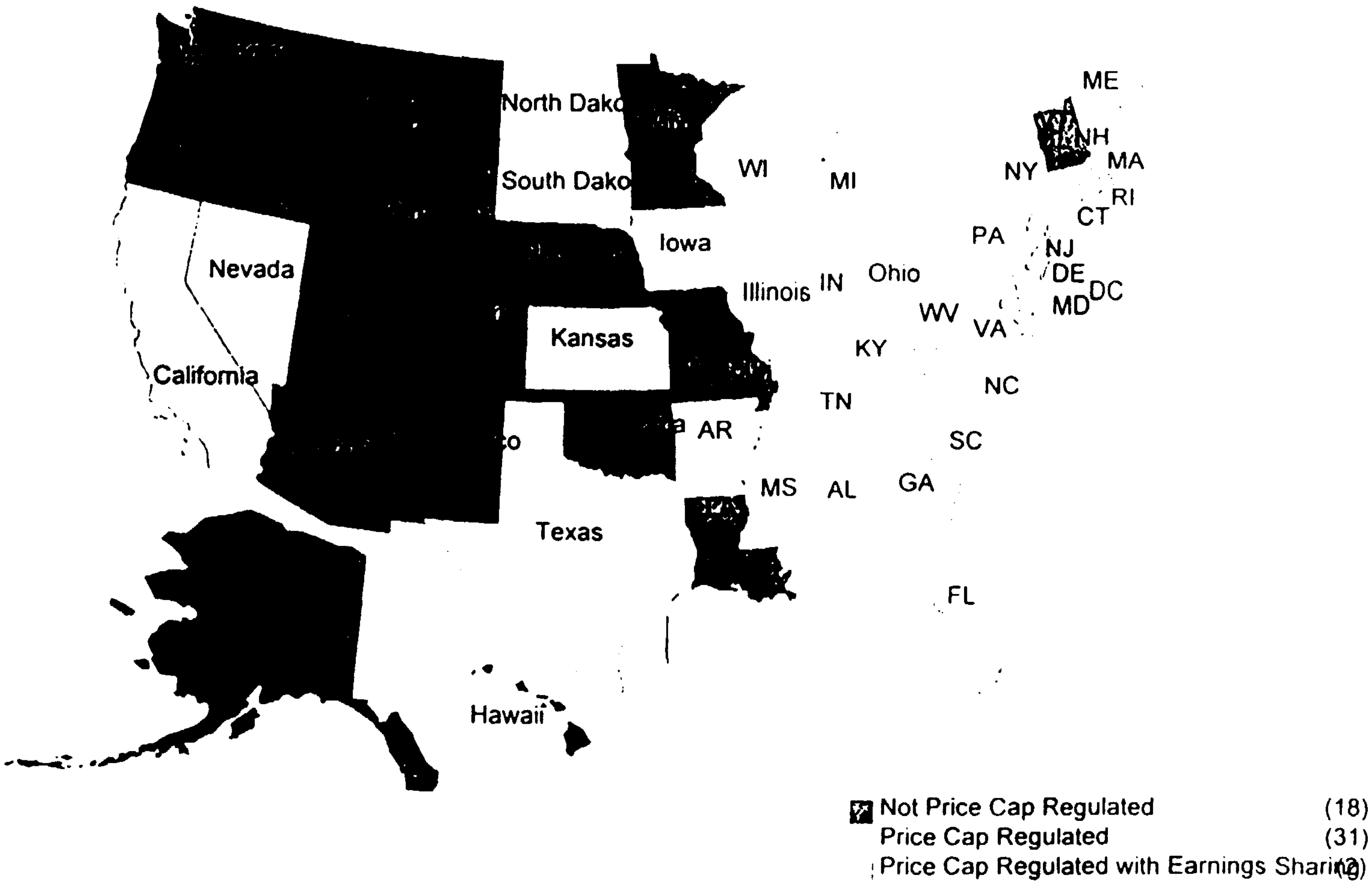
6 Notice at ¶¶ 38-41.

seeks comment on "whether there is a continued need to prescribe separations rules for ILECs operating under the existing price cap rules..."[7] While a separations process may be required, there is little economic use for separated costs and thus little to be gained by attempting to make the separations process more accurate.

14. First, the use of accounting earnings for state regulation of telephone companies is diminishing. Thirty-two states and the District of Columbia currently regulate telecommunications services using some kind of price cap method. Of those, only two-California and New Jersey-have explicit earnings sharing provisions in place today. Less than 18 states can be said to continue to regulate ILECs under anything resembling traditional rate base rate of return regulation, and according to the Notice, only about 24 percent of U.S. access lines were served in 1996 by ILECs regulated by rate of return regulation in the intrastate jurisdiction and by price caps in the interstate. Figure 1 shows clearly that price caps with no explicit tie to earnings is the dominant form of intrastate telecommunications regulation in the U.S.

[7] Notice at ¶ 41.

Figure 1: Forms of Telecommunications Regulation Across the United States



15. The Notice (at ¶ 41) seeks comment regarding state price cap plans which include "features in which reported earnings are relevant." There are features (beyond explicit earnings sharing) in some of these state price cap plans in which accounting costs or earnings play a role and, therefore, for which some need for separated costs remains. For example, nearly all state price cap plans continue traditional monitoring requirements, including monitoring of an intrastate rate of return. State plans are subject to widely differing periods for review, and no state plan, to my knowledge, excludes rate of return as a relevant datum-among others-by which the success of a plan and the reasonableness of its parameters may be judged. At least 19 state plans permit or require adjustments to the price cap index to account for exogenous cost changes, and the basis for that calculation in many state plans today is the effect of the exogenous event on separated intrastate costs.

16. Second, on the federal side, the price cap reform decision has largely eliminated reliance on separated costs for regulating price-cap companies. According to the Notice, about 92 percent of U.S. access lines are served by ILECs whose interstate services are price-cap regulated, and in the most recent price cap reform order, earnings sharing-requiring separated costs-was abolished as part of the plan all together.

> ...[S]haring severely blunts the efficiency incentives of price cap regulation by reducing the rewards of LEC efforts and decisions. These reduced incentives...can be expected to generate lower LEC efficiency, which in turn would reduce the benefits of price caps to consumers.[8]

Thus, except for a possibly short transition period, there is no need to maintain separated costs in order to implement interstate earnings sharing under the price cap plan.

17. Third, the Notice (at ¶ 40) observes that separated costs are necessary to implement exogenous cost changes in the federal plan, and the same logic applies to state price cap plans. However, there is nothing inherent in the economics of price cap regulation that requires that the price cap index be

[8] Fourth Report and Order in CC Docket No. 94-1, Second Report and Order in CC Docket No. 96-262, released May 21, 1997 at ¶ 147 [footnote omitted].

adjusted by the change in separated interstate costs in the interstate jurisdiction and separated intrastate costs in the state jurisdiction. An accurate assessment could be made of the effect of an exogenous change on the total (unseparated) costs of particular services provided by the ILEC-including carrier access, provision of unbundled network elements, local interconnection, retail telecommunications services and resale of those retail services-and the appropriate change to the interstate and intrastate price cap indices could be calculated that reflected the unit changes in total (unseparated) costs. Thus, the need to adjust the price cap indices to reflect exogenous events does not require that changes in separated costs be calculated.

B. Market and Technological Developments

18. As price cap regulation makes separations less necessary, competition-and particularly competition to supply bundles of services-makes the separations process more difficult and the consequences of changes in separations factors more costly. The Notice (at ¶¶ 55-71) recognizes some of the difficulties in applying current procedures to new services based on different technologies. More fundamentally, however, the traditional notion of jurisdictional services (interstate and intrastate toll, local exchange services, etc.) whose costs form the basis for jurisdictionally separated costs is rapidly becoming obsolete. When an ILEC offers its customers a package deal including local exchange service and two hours of long distance calling for $39.95 per month, both the revenue and the cost of that package is jurisdictionally ambiguous. Just as there is no economically correct method to assign common costs of local and long distance services to services or jurisdictions, there is no economically valid way to apportion revenues from services supplied in fixed proportions to packages to the individual services.

19. The Telecommunications Act of 1996 opened all U.S. telecommunications markets to competition. If separated costs have any effect on ILEC-and only ILEC-prices, the resulting competition

will be inefficient, and customers will not necessarily benefit from the introduction of competition. The result would obviously not be competitively neutral:

> our separations rules may hinder an ILEC's ability to compete by limiting its flexibility to recover costs according to market demand. While a competitive LEC is free to recover costs according to market demand, an ILEC subject to our jurisdictional separations rules may only attempt to recover costs classified as interstate through charges for interstate services, and costs classified as intrastate through changes for intrastate services. (Notice at ¶ 19)

For entry, or the threat of entry, to foster technical and dynamic efficiency in these markets, all competitors must have the same ability to respond to opportunities with flexible packaging, pricing and service quality options to meet customer demands.

20. Finally, as competition continues to increase in current telecommunications markets, the inevitable competitive losses of the ILEC would trigger an uneconomic, and perhaps unpredictable, shift in separated costs between the jurisdictions. Since a large portion of the costs assigned jurisdictionally using separations factors based on relative use are shared fixed and common costs, the shift in separated costs will have no relationship with the actual change in costs brought about by ILEC losses to competition. Changes in earnings (for ordinary monitoring purposes or for price cap earnings sharing or low end adjustments) using separated costs thus can tell the regulator little about the economic effects of competition on the ILEC.

21. Implicit in this discussion is the belief that refinements to the current separations procedures to account for changes in markets and technology would be ill-advised. Changes in marketing and technology make the jurisdictional assignment of service costs and revenues more difficult, and the relationships among shared fixed, common and directly assigned costs for services will change as new services and new technologies come on line. Changes in separations rules that increased the dependence between regulated prices and separated costs would not be competitively neutral, because only ILECs'

prices would be affected by the changes. In these circumstances, improvements to the separations toolkit are hardly warranted.

C. Nevertheless, Separations is Still Needed on a Transitional Basis

22. Price regulation for ILEC services, it should be remembered, is, itself a transitional mechanism, protecting consumers from ILEC market power until market forces perform that function more efficiently. At the same time, state and federal price cap plans are also transitioning away from explicit reliance on measured accounting costs or rates of return.

> ...[E]limination of sharing reduces our reliance on, and thus the importance of, jurisdictionally separated embedded costs. The sharing obligation is triggered when a price cap carrier reports interstate earnings above a specified level. Reported earnings are calculated on the portion of embedded investment and expenses that are allocated to the interstate jurisdiction by part 36, the jurisdictional separations manual. Interstate rate base and expense levels, and thus reported earnings, are also directly affected by accounting depreciation rates, which we prescribe for most incumbent price cap LECs. By contrast, in a competitive marketplace, decisions are governed by economic costs and economic depreciation rates. Reduced reliance on accounting costs thus facilitates our transition to the competitive paradigm of the 1996 Act.[9]

Nonetheless, until the vestiges of accounting-cost based regulation are removed, there will be an unavoidable need to separate costs between regulatory jurisdictions. As discussed above, such calculations will have limited economic meaning, will become more difficult and will interfere more in the competitive process than they have in the past. In this choice among unpleasant alternatives, is there a workable solution?

IV. A Modest Reform Proposal

23. In light of these problems, it appears likely that a simple freeze in separations factors will come closer to meeting the Commission's criteria of competitive neutrality, administrative simplicity and adherence to cost causality than the continued application of the current Part 36 Rules or any wholesale refinement of those rules.

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[9] Fourth Report and Order in CC Docket No. 94-1, Second Report and Order in CC Docket No. 96-262, released May 21, 1997 at ¶ 152.

A. Freezing Separations Factors Corrects Incentive Distortions

24. Recall the economic logic underlying the move from rate of return to price cap regulation. Originally, rate of return regulation was justified by the belief that welfare losses would be smaller if regulated firms were required to price to recover no more than their embedded accounting costs than if their prices were unregulated. The subsequent evolution towards price cap regulation recognized that there would be welfare gains from removing the distorted incentives to reduce costs and expand output, even though differences between regulated prices and accounting costs could increase.[10] Oddly enough, the link between accounting costs and prices under price cap regulation was effectively broken by freezing it -- setting the price cap index and the average price index at 100 at the outset -- and then changing the price cap index over time by factors unrelated to accounting costs.

25. A similar logic applies to separations reform. Assume that some relationship remains for some regulated ILECs between jurisdictionally separated accounting costs and some parameters of price regulation.[11] When such firms determine their product offerings, packages and prices in increasingly competitive markets, they must also take into account the effect of their actions on jurisdictional separations factors which, in turn, affect the prices that they can charge in one jurisdiction or the other. For example, some wireless companies today charge nothing for usage off-peak, recognizing that most costs are driven by the need to invest to meet peak period capacity requirements. A regulated ILEC might find it profitable to price usage similarly to compete, setting local or toll usage prices at zero during off-peak periods. Under current separations rules with factors based on relative usage, however, the firm might have a diminished incentive to introduce such pricing because the resulting shift in relative usage across jurisdictions could affect jurisdictional cost assignments which, in turn, could affect

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10 Richard Schmalensee, "Good Regulatory Regimes," RAND Journal of Economics 20(3), Autumn 1989 at 417-36.

11 Earnings sharing is an example of an explicit relationship between costs and prices. An example of an implicit relationship is the perennial need to review price cap plans and use accounting earnings as a factor in resetting plan parameters.

the prices that could be set by the regulated firm. Because the bulk of the shift in costs between jurisdictions would be the (uneconomic) shift of shared fixed and common costs, the change in separated costs and consequent changes in relative prices would not have any economic efficiency justification.

26. A freeze in separations factors at their current levels would mitigate this distortion in incentives. Freezing separations factors would mean that the regulated firm would make pricing and product decisions that ignored the effects of changes in jurisdictional cost assignments. Because those changes in costs today do not reflect changes in economic costs, the incentives of the regulated firm would be closer to those of unregulated firms in competitive markets when separations factors are held constant. As a result, freezing separations factors at their current levels provides a useful balance of the Commission's stated objectives for the separations process. A freeze in current factors at current levels is obviously the most administratively simple proposal possible; since factors will not change over time, a freeze is less onerous than continuing the separations process intact. Freezing factors is much more administratively simple than creating new factors and allocation rules to try to adapt the current system to new market structures and new technologies. A freeze would also move the process closer to competitive neutrality. The separations process assigns shared fixed and common costs to groups of services and jurisdictions-and since there is no economically valid method of performing that assignment-to the extent that separated costs affect prices to any extent, the process will not be competitively neutral. Nonetheless, if separations factors were frozen, ILECs would no longer have to take into account the effects of their marketing decisions on separations factors bringing them-in this respect-to competitive parity with CLECs, to which separations rules do not apply. Finally, with respect to fidelity to cost causation principles of assignment, frozen factors may assign economic (incremental) costs less accurately than variable factors, but

- like price cap regulation, weakening the relationship between accounting costs and prices may lead to losses in allocative efficiency if resulting prices differ more from economic costs. However, like price cap regulation, such potential efficiency losses are likely to be more than offset by dynamic and technical efficiency gains from correcting the incentives under which the regulated firm operates, and

- directly assigned costs-the ones that reasonably reflect economic incremental costs-are only one component in separated costs. Thus, a system that assigns direct costs more accurately but distorts incentives to price, package and invest may result in prices that are further from economic costs than a system that assigns direct costs less accurately but with correct incentives.

27. There is evidence that a freeze in separations factors may not produce different results than would the direct assignment of costs, so that a freeze would simplify the current process without yielding significant differences in the quality of the outcome. Despite the complexity of the separations rules and the recent changes in market structures and technology, separations factors for the large ILECs have remained relatively constant over time.[12]

B. Modifying separations rules for the new environment creates new difficulties.

28. As discussed above, competitive losses by ILECs as markets are opened to competition will have the effect of changing separations factors based on relative use. Required adjustments would be more frequent than in the past and less predictable. The connection between those adjustments and the strategic decisions of the ILEC~~and~~ its competitors would necessarily affect the way those firms behave in the markets in which they compete.

29. Similarly, new services and new technological platforms for existing services will make implementation of separations rules more difficult and less accurate. Provision of multiple services over the same facility, each giving rise to different costs in the network, make separations distinctions among services -- e.g., message services and private line or wideband and voice grade -- difficult to maintain. Relationships among services and components of cost -- e.g., call setup time, need for full or half-duplex capacity -- have changed as services change and converge, so that the effects of separations algorithms that might have reflected economic cost changes in the past will no longer do so in the future. Similarly, the offering of traditional services in new ways -- e.g., virtual private line service -- creates a false distinction that incorrectly moves costs from one jurisdiction to another as the mix of services changes

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12 See Exhibit 3 to Bell Atlantic's filing here.

over time. In addition, the expansion of service offerings and the multiplicity of bundled services coming with competition means that a higher proportion of costs will fall into the categories of shared fixed and common. As it is the assignment of these components of cost for which separations algorithms are arbitrary, the economic problems associated with assigning arbitrary costs to service categories will be greater in the future than in the past. In view of these difficulties in modifying separations methods to deal with the new technological and market structure environment, in the long run, a freeze will do less harm than attempting to adapt current rules.

C. Creating service-specific separations factors will lead to economic incentive problems.

30. As discussed above, identification of individual services and assignment of revenues and costs to services will be more difficult in the future than in the past. Thus, if the Commission's separations rules assigned shared fixed and common costs to individual services-and if those allocated costs were used in any way to set or restrict ILEC prices-competitive parity would be violated. The Commission has recognized this problem in the past and agrees that separated costs have no use in pricing individual services:

> Our separations rules apportion costs among broadly defined classes of services, not among individual services. Because ILECs offer numerous services in each jurisdiction, and because the separations rules uniformly apply to ILECs having diverse cost structures, these rules are not intended to be sufficiently accurate to identify the costs incurred by individual services. State and federal regulators therefore use separations results to evaluate earnings for groups of services, not for evaluating the pricing of individual services.[13]

31. From the perspective of economic incentives, the objective is to ensure that the risks of competitive losses and new business ventures be borne entirely by ILEC shareholders and the benefits from them (if any) accrue to them as well. In practice, this means that purchasers of regulated ILEC services should collectively be made neither worse off nor better off by the entry of the ILEC into unregulated markets or by its competitive losses in other markets. Pure price cap regulation achieves this

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13 See, e.g., Notice at ¶ 26, footnote 53.

result, because prices charged for regulated services would be unchanged by any competitive activities. Were such a regulatory tool in effect in both the interstate and intrastate jurisdictions, voluntary ILEC investment in competitive activities would be undertaken only in expectation that incremental revenues would exceed incremental costs. In the words of A.E. Kahn

> The market knows how to encourage efficient investments and discourage inefficient ones. It does so by establishing the [following] two conditions...investors bear the entire additional costs and reap the full benefits; and purchasers of the regulated services bear none of those additional costs and receive none of the benefit. All this requires is that regulatory agencies leave the rates for regulated services, however set, unchanged by the new ventures.[14]

32. In particular, the Commission raises concerns in the Notice that its separations treatment of spare network facilities will become inadequate as "telecommunications networks evolve to provide more high-capacity services over fiber cables."[15] Indeed, the Commission tentatively concludes that

> Ratepayers of voice-grade services, over which ILECs still exert market power, should not be paying for the spare facilities that eventually will be used for more competitive services (Notice at ¶ 71)

fearing that spare facilities ultimately to be used for competitive high-capacity services could be classified as plant assigned to voice-grade telephone services. The economic answer to this concern is not to devise cost assignment mechanisms that more accurately reflects the intended future use of the spare facility. When different services share a common facility, it is not the ultimate use of a given component of that facility that causes a cost to be incurred; rather it is the contemporaneous use by the subscriber. The economic answer to the Commission's concern is already addressed in current regulation. The prices of non-competitive services are capped, so the stockholders of the regulated firm bear the risk of holding capacity for future use.

14 A.E. Kahn, "How to Treat the Costs of Shared Voice and Video Networks in a Post-Regulatory Age," Policy Analysis, Vol. No. 264, November 27, 1996 at 20.

15 Notice at ¶ 70.

33. The Commission must resist the temptation to specify through accounting rules how shared fixed costs (e.g., of a broadband network platform) and common costs must be recovered from current competitive and noncompetitive services and from future services. Since shared facilities support current and future services, regulated and unregulated, and because they lower the cost of maintaining and provisioning current services, it would be economically incorrect to require that the shared fixed costs be recovered entirely from only one of the many services that it will make available. Rather, the price of each service that shares these facilities should be required to recover at least the incremental cost of the service, and, together, revenue from all services that share the facilities must recover the shared fixed costs of the facilities. Just as multiproduct firms in competitive markets recover shared fixed and common costs from all of the services they supply in proportions that depend on market conditions for different services, the costs of the shared facilities should be recovered from all services that use the facilities. Arbitrary cost allocations should not force the price of any service so high above its incremental cost that its contribution to the shared fixed and common costs is diminished.

William E. Taylor

Subscribed and sworn to before me this
8th day of December, 1997.

Notary Public

My Commission expires

GTE & REGIONAL BELL OPERATING COMPANIES' 1993 - 1999 TOTAL INTERSTATE RATIOS

Year	Total Plant in Service	Absolute Deviation from 7-yr Average
1993	24.94%	.0087
1994	25.11%	.0070
1995	25.58%	.0023
1996	25.88%	.0007
1997	25.91%	.0009
1998	26.46%	.0065
1999	26.79%	.0098
Average	25.81%	

Source: ARMIS 43-04 reports

THE VERIZON TELEPHONE COMPANIES

The Verizon telephone companies are the local exchange carriers affiliated with Verizon Communications Inc. These are:

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Contel of the South, Inc. d/b/a Verizon Mid-States
GTE Alaska Incorporated d/b/a Verizon Alaska
GTE Arkansas Incorporated d/b/a Verizon Arkansas
GTE Midwest Incorporated d/b/a Verizon Midwest
GTE Southwest Incorporated d/b/a Verizon Southwest
The Micronesian Telecommunications Corporation
Verizon California Inc.
Verizon Delaware Inc.
Verizon Florida Inc.
Verizon Hawaii Inc.
Verizon Maryland Inc.
Verizon New England Inc.
Verizon New Jersey Inc.
Verizon New York Inc.
Verizon North Inc.
Verizon Northwest Inc.
Verizon Pennsylvania Inc.
Verizon South Inc.
Verizon Virginia Inc.
Verizon Washington, DC Inc.
Verizon West Coast Inc.
Verizon West Virginia Inc.

CERTIFICATE OF SERVICE

I hereby certify that on this 25th day of September, 2000, copies of the "Comments of Verizon on Joint Board Recommended Decision" were sent by first class mail, postage prepaid, to the parties on the attached list.

Jennifer L. Hoh

* Via hand delivery.
\+ By Facsimile

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